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C O N F I D E N T I A L SECTION 01 OF 02 ROME 000062

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E.O. 12958: DECL: 01/15/2020
TAGS: EFIN ECON IT
SUBJECT: ITALY 2010 ECONOMIC OUTLOOK - FRAGILE RECOVERY
AHEAD

ROME 00000062 001.2 OF 002

Classified By: Minister Counselor for Economics George White, for reaso
ns 1.4 (b) and (d)

¶1. (C) Summary -- Forecasters expect the Italian economy to grow modestly in 2010, with inflation remaining in check. Bank lending is still slow and some bank ratings have been downgraded slightly. Having managed the worst of the 2009 crisis creditably, the GOI will remain primarily preoccupied with tight public finances and growing unemployment in 2010. Italy's debt load is high but serviceable; Italy is not suffering Greece-like troubles. Post expects Italian policymakers, therefore, to focus inwardly in 2010, leaving to other governments the advocacy of international financial regulatory reform. Spring elections increase the risk for populist economic policy moves. End Summary.

2010 - GOI Navigates Challenging Year

¶2. (U) Economists and the government forecast that Italian GDP will grow somewhere between 0.1 percent and 0.8 percent in 2010, with most of that growth occurring toward the end of the year. On the heels of the biggest GDP drop (4.8 percent) since the 1930's, even modest growth will be a relief. Italy's recovery depends on a resurgence of exports, especially manufactured goods, to its EU neighbors and the US. Policymakers will thus keep a close eye on Germany's prospects (exports dramatically down in December 2009), the U.S. economy, and the dollar-euro exchange rate.

¶3. (U) Domestic demand will likely remain subdued in 2010, as households feel the pinch of expiring unemployment benefits. Sales of durable goods in 4Q 09 were already ten percent below the level at the end of 2007. Through 2009 the GOI managed a difficult economic climate relatively well, mitigating the recession's effect on households, firms, and the financial sector with a series of modest, prudent measures, such as cash-for clunkers to stimulate demand for automobiles, targeted tax relief, and small business credit lines and loan guarantees.

Bank Lending Slows Further

¶4. (U) According to the Bank of Italy, in November 2009, for the first time during this recession, credit to Italian firms actually fell (minus 1.0 percent from November 2008), while credit to households barely grew. Previously, credit growth

had slowed, but remained positive. The biggest drop in lending occurred among the country's five largest banks, as they tightened lending standards in the face of worsening credit quality, primarily due to bad business loans. The percentage of doubtful and non-performing loans approximately doubled since the fall of 2008, according to the Central Bank. While the trend is worrisome, the proportion of troubled loans remains modest, at around 2.5 percent. Still, Standard and Poors downgraded several large Italian banks in 2009 and predicts further downgrades in 2010, although most banks' ratings will remain solidly in the 'investment grade' range.

¶5. (U) Small, rural-based banks actually expanded credit to customers in November 2009, by about 5 percent, or half the average pre-crisis growth rate. Central Bank surveys indicate that loan demand will increase in the first quarter of 2010, even as banks continue to tighten standards and seek to conserve capital. A bright note in 2009 was large Italian banks' success in issuing new commercial paper and raising new capital.

No Inflation in Sight...

¶6. (U) Another silver lining in the 2009 recession was a consumer price index increase of 0.8 percent, the lowest since 1959. Forecasters expect inflation to rebound a bit in 2010, to around 1.5 percent, still well below the average of the ought years. Low interest rates also helped some household budgets in 2009, since over 80 percent of Italian mortgages have variable interest rates. These factors actually boosted Italians' purchasing power throughout much of 2009, a happy circumstance for anyone who had income

and/or a job.

... but Unemployment Starts to Bite

¶7. (SBU) Official unemployment reached 8.3 percent in November, with the government forecasting a continued rise to 8.9 percent throughout 2010. Outside observers such as the International Monetary Fund, however, estimate unemployment will exceed 10.5 percent and persist into the first half of ¶2011. This long and stubborn lag may be due to a build-up of excess productive capacity that Italian firms were able to mitigate in 2009 by shortening work hours, sending workers on mandatory vacations, and placing them in a government program (Cassa Integrazione) that provides workers income and precludes employers paying high severance costs.

¶8. (U) As employers tried to stave off layoffs, they also accumulated excess inventories, a fact that suggests re-hiring will be slow. Also working against a quick job recovery will be the relatively high indebtedness of Italian firms, with corporate debt equal to about 80 percent of GDP, third only to Spain and the UK in the euro area.

Public Finances Still Daunting

¶9. (C) The prospect of high unemployment and a yawning central government deficit (5 percent of GDP forecast in 2010) will keep Italian policymakers scrambling to boost revenue (without raising taxes) and control spending. The tax amnesty the government launched in December in force until April 2010 has raised around five billion euros, but has probably run its course by now. PM Silvio Berlusconi on January 8 raised eyebrows when he suggested cutting tax rates as a way to broaden Italy's tax base. He retreated quickly, pledging no tax cuts for the duration of the crisis. Meanwhile, his Finance Ministry forecast Italy's debt-to-GDP ratio would rise to 118 percent next year.

No Greece Problem Here

¶10. (C) Central Bank experts foresee no difficulty in financing the additional deficit and servicing existing debt, however (more septel), as less than 10 percent of it is short-term, i.e. due in less than one year. Bank officials told econoffs on January 14 that the GOI had no problems issuing new bonds throughout 2009 and even succeeded in lowering the overall interest rate on its debt. Italy's sovereign credit rating, also recently downgraded by S&P (AA-), remains in the 'investment grade' range.

Charity Begins at Home

¶11. (C) Comment: Preventing unemployment from dragging the Italian economy into a double-dip recession is likely to head policymakers' agenda during the first half of 2010. This means that as the various G groupings (G-2, G-20, etc. again take up international financial sector regulation and mechanisms for sustainable global economic activity , US officials will likely find Italian policymakers reluctant to play leading roles. Post expects GOI officials will, rather, remain focused on home, alert to the needs of Italy's fragile recovery, especially as the Spring regional elections approach. Berlusconi,s backtracking on tax cuts was encouraging, but we wouldn't be surprised if he comes up with some sort of surprise tax cut in the run-up to the elections.
THORNE